

MiFID II

Safeguarding of client assets

December 2016

Key Points

- Firms will be required to appoint a single officer with specific responsibility for client assets.
- Title transfer collateral arrangements ("TTCAs") will be prohibited for retail clients, and additional requirements will apply if firms wish to use TTCAs for other types of client.
- Firms entering into securities financing transactions must (i) obtain the express prior consent of the client and (ii) ensure that the borrower of the client's assets provides appropriate collateral.
- Firms who deposit client funds with third parties must consider the diversification of these funds as part of their due diligence and the arrangements for holding the funds.
- Firms can only have security interests, liens or rights of set-off over client assets where required by applicable law in a third country.
- Firms must put in safeguarding arrangements as an alternative to segregating assets, when they cannot comply with segregation requirements in third country jurisdictions due to reasons of applicable law.
- Firms will be subject to additional information and record keeping requirements, for the benefit of for insolvency practitioners and relevant authorities in the event that the firm becomes insolvent.

Background

Articles 13(7) and 13(8) of the MiFID I Directive contain high level obligations requiring firms to have adequate arrangements in place to safeguard clients' rights in a situation where the firm holds financial instruments or funds belonging to the clients. Under the MiFID I Directive, further detailed provisions are contained in Articles 2 to 8 of the MiFID II Delegated Regulation.¹

The high level obligations in MiFID I remain unchanged by MiFID II. The European Commission has adopted the MiFID II Delegated Regulation based on ESMA's Technical Advice, and includes a number of specific requirements for investment firms in addition to those high level obligations in the MiFID I Directive.

MiFID II proposes the changes outlined below.

Governance arrangements

Firms will be required to appoint a single officer with overall responsibility for the firm's safeguarding of client instruments and funds. This does not have to be a distinct function with sole responsibility for the oversight of client assets; it could, for example, be part of a compliance officer's function.

The single officer should be of a sufficient level of skill and authority in order to discharge their duties effectively and without impediment.

Use of TTCAs

TTCAs are arrangements under which a client transfers his rights in a financial instrument to the firm (often as part of providing collateral or security to the firm in respect of the client's obligations to the firm). Under the TTCA, the instrument belongs to the firm and the client ceases to have any protections under the safeguarding provisions of MiFID in relation to that instrument.

Article 16(10) of the MiFID II Directive prohibits firms from concluding TTCAs with retail clients in any circumstances.

The MiFID II Delegated Regulation also makes clear that even for non-retail clients, investment firms shall not conclude TTCAs without proper consideration of the appropriateness of the TTCA in relation to that client. The MiFID II Delegated Regulation states that investment firms must take into account all of the following factors:

European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (the "**MiFID II Delegated Regulation**"). For earlier advice on this issue see ESMA, Final Report: Technical Advice to the Commission on MiFID II and MiFIR, 19 December 2014 (ESMA/2014/1569) (the "**Technical Advice**"), Chapter 2.8.

¹ Commission Delegated Regulation (EU) of 25 April 2016 supplementing Directive 2014/65/EU of the

- whether there is only a very weak connection between the client's obligation to the firm and the use of TTCAs, including whether the likelihood of a client's liability arising is low or negligible;
- whether the amount of client funds or financial instruments subject to TTCAs far exceeds the client's obligation or is even unlimited if the client has any obligation at all to the firm; or
- whether all clients' financial assets are made subject to TTCAs, without consideration of what obligation each client has to the firm.

The MiFID II Delegated Regulation states that firms will not be prevented from taking "appropriate security" against a client's obligations, and accepts that this may involve the taking of sufficient collateral. ESMA has separately stated its view that this would not prevent compliance with legal requirements under EU legislation such as EMIR.

Where TTCAs are permitted, firms must highlight to clients the risks involved and the effect of any TTCA on the clients' assets.

Securities financing

Article 19 of the MiFID Implementing Directive currently permits firms to engage in securities financing transactions (e.g. stock lending and repo transactions) in certain circumstances. These transactions would typically involve the firm in transferring the title in the instruments affected to a third party, subject to an obligation to provide equivalent instruments back to the client at a specified point in the future.

The MiFID II Delegated Regulation states that:

- It will not be possible to effect TTCA arrangements that are prohibited under Article 16(10) of the MiFID II Directive.
- Firms must adopt specific arrangements for both retail and non-retail clients to ensure that the borrower of client financial instruments provides the appropriate collateral and that the firm monitors the continued appropriateness of such collateral and takes the necessary steps to maintain the balance

with the value of client financial instruments.

- Where a firm enters into arrangements for securities financing transactions, the prior express consent of the client to the use of the instruments on specified terms must be clear, recorded in writing, and affirmatively executed by signature or equivalent. The use of that client's financial instruments is restricted to the specified terms to which the client consents.

Diversification of client funds

Under Article 4 of the MiFID II Delegated Regulation, firms are required to undertake due diligence in relation to the institutions with whom they deposit client funds and the arrangements for the holding of those funds.

The MiFID II Delegated Regulation states that, as part of that due diligence, firms should consider the diversification of these funds.

The requirement to diversify will not apply where a firm has transferred client funds to a transaction account in order to make a specific transaction, i.e. where client funds have been placed merely for the purpose of executing a transaction for the client.

Intragroup deposits of client funds

Under the MiFID II Delegated Regulation, a firm which deposits client funds at a third party will only be able to deposit a maximum of 20 per cent of such funds with another member of its own group. That requirement will, however, be subject to a proportionality requirement, so that the firm can avoid complying with this requirement if, for example, it only holds a small balance of client funds.

Security interests, liens and rights of set-off

Under the MiFID II Delegated Regulation, firms will not be permitted to have security interests, liens or rights of set-off over client assets that enable a third party to dispose of these assets in order to recover debts that do not relate to the clients or provision of services to the clients (except in cases where this is required by applicable law in a third country jurisdiction).

Where a firm is obliged to enter into agreements that create such security interests, liens or rights of set-off, the firm will be required to disclose this information to clients indicating to them the risks associated with these arrangements.

Where security interests, liens or rights of set-off are granted by the firm over client assets, or where the firm has been informed that they are granted, these must be recorded in client contracts and the firm's own accounts to make the ownership status of client assets clear (e.g. in the event of an insolvency).

Segregation of client financial instruments in third country jurisdictions

Article 16(1)(d) of the MiFID Implementing Directive currently requires a firm to ensure that financial instruments deposited with a third party are identified separately from any instruments belonging to the firm, by means of differently titled accounts or "other equivalent measures to achieve the same level of protection".

The MiFID II Delegated Regulation says that if, for reasons of applicable law, firms cannot comply with these segregation requirements, firms must put in place arrangements to ensure clients' assets are safeguarded in order to meet the same objectives.

Preventing unauthorised use of client financial instruments

Under the MiFID II Delegated Regulation, firms must take appropriate measures to prevent the unauthorised use of client financial instruments, including (but not limited to):

- agreeing with the client what will happen if the client does not have enough provision on its account on the settlement date (e.g. borrowing of the corresponding securities on behalf of the client or unwinding the position);
- the close monitoring by the firm of its projected ability to deliver on the settlement date and the putting in place remedial measures if this cannot be done; and

- the close monitoring and prompt requesting of undelivered securities outstanding on the settlement day and beyond.

Information for insolvency practitioners and relevant authorities

Firms will be required to make information readily available to national regulators, insolvency practitioners and those responsible for the resolution of failed institutions, including:

- related internal accounts and records (reconciliations, client ledgers, cash books etc.) that readily identify the balances of funds and instruments held for each client;
- where client funds are held by the firm in accordance with Article 4 of the MiFID II Delegated Regulation, details of the accounts where client funds are held (bank or qualifying money market fund) and the relevant agreements with those entities;
- where financial instruments held by the investment firm in accordance with Article 3 of the MiFID II Delegated Regulation, details of accounts opened with third parties and the relevant agreements with those entities;
- details of third parties carrying out any related (outsourced) tasks;
- key individuals of the firm involved in related processes, including those responsible for oversight of the firm's requirements in relation to the safeguarding of client assets; and
- relevant client agreements.

The record-keeping requirements currently contained in Article 2 of the MiFID II Delegated Regulation will be amended so that records should be maintained in such a way "that they may be used as an audit trail", in line with IOSCO Principle 1.

Timescales for implementation

The MiFID II Directive and the Markets in Financial Instruments Regulation ("MiFIR") came into force on 3 July 2014, and most of

their provisions will come into effect in member states from 3 January 2018. Member states have until 3 July 2017 to transpose the MiFID II Directive into national law.

The changes to the MiFID Implementing Directive will be made by way of the MiFID II Delegated Regulation which will become effective on 3 January 2018. The member states will not need to implement the Delegated Regulation into national law, because it will be directly effective in member states.

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